



Directorate of
Intelligence

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**International
Economic & Energy
Weekly**

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9 November 1984

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DI IEEW 84-045
9 November 1984

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Economic & Energy
Weekly**

25X1

9 November 1984

25X1

iii

Synopsis

1

Perspective—Poland: The Persistent Debt Dilemma

25X1

5135

 EURA

3

Briefs

Energy

International Finance

Global and Regional Developments

National Developments

25X1

25X1

15

OPEC and the Oil Market: Not Out of the Woods Yet

25X1

9200

 OGI

25X1

21

Brazil: A Critical Role for Exports

954

 ALA

25X6

1516

25X1

33

Saudi Arabia: Petrochemical Exports Assault Glutted Market

25X1

1946

 NESA

25X1

39

Export Processing Zones: Contributions to LDC Development

25X1

1360

 OGI

25X1

25X1

25X1

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**International
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Synopsis

1

Perspective—Poland: The Persistent Debt Dilemma

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Poland's financial crisis has become a trap from which neither Warsaw nor its creditors are likely to escape for many years. Poland faces a long period of austerity, and continued tough decisions on the allocation of scarce hard currency, the degree of austerity the populace will accept, and the concessions it will have to make to obtain financial help from the West.

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15

OPEC and the Oil Market: Not Out of the Woods Yet

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OPEC's decision at its emergency meeting last week to defend the \$29 per barrel benchmark price by reducing production quotas is at best a short-term solution to the more fundamental issues confronting the organization. OPEC continues to face a very slow rate of growth in the demand for its oil, however, and must either find a way to strengthen faltering discipline or face further reductions in oil prices.

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21

Brazil: A Critical Role for Exports

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Brazil is counting heavily on rapid export growth to meet its foreign debt obligations and launch a recovery from its prolonged and socially unsettling economic recession. Brazil's prospects for exporting its way out of its debt crisis during the remainder of the 1980s appear good but depend on a healthy world economy and a continuing commitment by Brazil's new civilian government to implement prudent export policies.

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DI IEEW 84-045
9 November 1984

Secret

25X1

33

Saudi Arabia: Petrochemical Exports Assault Glutted Market

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Saudi Arabia's expanding petrochemical exports are starting to generate trade frictions with industrial countries, particularly in Western Europe. We believe trade problems will mount as low-cost Saudi petrochemicals enter the glutted global petrochemical market in a big way by the end of 1985.

25X1

39

Export Processing Zones: Contributions to LDC Development

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During the last 15 years, export processing zones (EPZs) have become a rapidly growing phenomenon in developing countries. These enclaves provide industrial infrastructure as well as special tariff, fiscal, and regulatory concessions, and have become an important mechanism for attracting export-oriented foreign investment to developing countries.

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9 November 1984

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Economic & Energy
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9 November 1984

Perspective

**Poland:
The Persistent Debt Dilemma**

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Poland's financial crisis has become a trap from which neither Warsaw nor its creditors are likely to escape for many years. Poland faces a long period of austerity and continued tough decisions on the allocation of scarce hard currency, the degree of austerity the populace will accept, and the concessions it will have to make to obtain financial help from the West. Western banks and governments face the problem of how to share Warsaw's limited payment capacity and how to deal with demands for extremely generous debt relief and new credits.

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While the danger of default has receded, Warsaw has made little real progress since it first requested debt rescheduling in March 1981:

- The Poles are in the third year of a moratorium on payments to Western governments during which arrears have risen to \$11 billion, while banks have continued to provide debt relief.
- Warsaw cannot cover even the interest on its debt, and interest arrears now amount to \$2.5 billion.
- The most positive development, Poland's trade surpluses, has been achieved mainly by slashing imports rather than by boosting exports.

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The moratorium on payments to Western government creditors has allowed Warsaw to use its scarce hard currency to support economic growth. While imports are down, Poland has continued to give greater priority to imports than to repaying debt in order to halt the slide in national income and to supply enough consumer goods to maintain political tranquillity. This is inconsistent with addressing Poland's short-term financial problems and restoring long-term creditworthiness.

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We expect that debt service obligations will swamp Poland's payment capacity for several more years:

- Warsaw is unlikely to cover repayments of already rescheduled bank debt that begin next year, raising the prospect of repeated reschedulings.
- Poland probably will be unable to increase exports sufficiently to stem the growth of its debt in this decade.
- Warsaw's poor credit rating and the problem of burden sharing among creditors will block new loans—the only alternative to large trade surpluses.

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DI IEEW 84-045
9 November 1984

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Insolvency leaves the regime with few options, none of which is attractive. Internal debates about debt policy are likely to continue, slowing negotiations with creditors and blocking bold policy measures:

- Poland could maintain its relatively low priority on debt servicing in favor of imports. This policy, however, would block any return to creditworthiness and increase the eventual costs of dealing with the debt problem.
- The regime could tackle the debt problem head-on by imposing greater austerity, but the regime fears that the resulting drop in living standards would risk unrest.
- A third option would be a rapprochement with the West, involving a generous rescheduling package from the Paris Club, IMF membership, and new credits. This is not likely, given continuing Western concerns about the Polish political and economic situation and likely Soviet objections to such cooperation. [redacted]

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We expect Warsaw to continue its policy of gradual adjustment, running a trade surplus large enough to meet creditors' minimum demands but tempering austerity to avoid popular unrest. While this strategy prevents default and domestic instability in the short run, it almost guarantees economic stagnation, no gains in living standards, and no escape from the debt trap. [redacted]

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Warsaw clings to this strategy in the hope that the West will provide a large financial package without strings attached. Until Poland accepts that it must take the first steps—short-term austerity, fundamental economic reform, and sound economic policies—little real progress is possible. In any event, the pivotal role of Western governments means that political factors will continue to play a major role in Warsaw's financial prospects. With this in mind, the Poles, Allied governments, and bank creditors will closely watch Washington's policy toward Poland. [redacted]

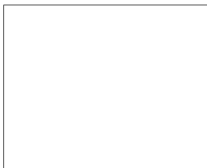
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Briefs**Energy***Egypt Reneging on Oil
Production Cuts*

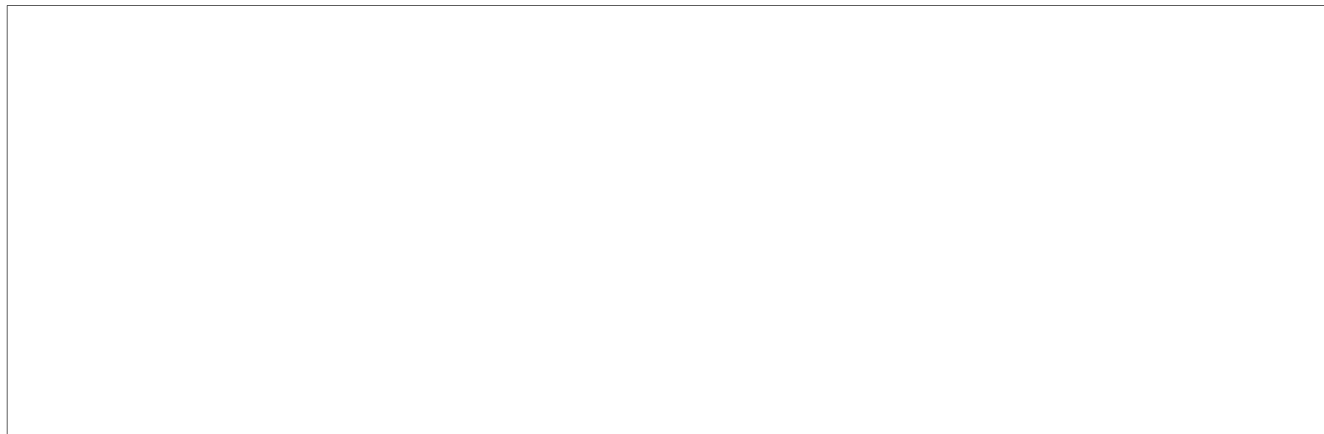
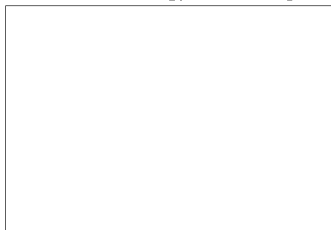
Cairo evidently has decided that the need to maximize foreign exchange earnings permits only rhetorical support for OPEC aims, despite the political gains it has achieved by expressing solidarity with OPEC. According to the US Embassy, reliable industry sources believe Egypt will not follow through on its promise to OPEC to reduce daily production by 30,000 barrels. It will instead obscure its level of oil production by basing the supposed reduction on the 900,000-barrel-per-day combined production rate for oil and natural gas.



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*USSR Disclaims
UK Energy Embargo*

The USSR informed [redacted] that the announcement of an energy embargo against the United Kingdom, in sympathy with the British coal miners strike, was unauthorized. The Soviets said that their goal is still to double trade with the United Kingdom. Last weekend, the Soviet press disclaimed "allegations" in the Western press that the Soviets were using trade for political purposes, and declared that the USSR "will always honor signed contracts." The reversal probably reflects fears that the move backfired as a political gesture and may be a further indication of disarray in Soviet leadership circles. Nevertheless, the affair has been damaging because serious questions have been raised again in the West about dependence upon Soviet energy supplies.



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9 November 1984

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*Malaysia Slows
Growth of Oil
Production*

Kuala Lumpur plans to increase oil production by only 2.3 percent next year to 450,000 barrels per day, according to the 1985 budget released last month. Malaysia, which is not a member of OPEC, has boosted oil production by an average annual rate of 20 percent over the past three years to offset declining commodity export earnings. The recent turnaround in the trade balance—projected to reach a \$2.1 billion surplus this year—reduced the government's need for foreign exchange earnings and tax revenue. Should oil prices fall substantially in the near future, however, Malaysia would probably raise output again to prevent its trade balance from deteriorating. [redacted]

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*Iraq-Saudi Arabia
Pipeline Problems*

The December 1984 startup of construction on the Saudi portion of the Iraq-Saudi Arabia pipeline will be delayed at least a month apparently because land ownership claims are disrupting survey work, [redacted] Riyadh has so far refused to intercede, but it remains unclear whether the government's inaction is an attempt to discreetly hinder construction. Riyadh uses established land acquisition procedures to maintain political influence among the tribes through redistribution of the oil wealth. Pipeline right-of-way purchases, which we estimate could double the \$508 million project cost, would create financing problems if Baghdad is forced to pay these claims at the outset rather than through a deferred payment plan. Construction of the 200-kilometer Iraqi section of the pipeline started in October 1984 and will be completed by June 1985 [redacted]

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International Finance

*Argentina Steps
Up Devaluations*

Buenos Aires devalued the peso 6.8 percent on 29 October—the largest single exchange rate adjustment in 1984. Although small daily devaluations failed to keep pace with rapid domestic inflation during the first three quarters, in October, cumulative devaluations of nearly 31 percent exceeded the estimated 20-percent inflation. The impact on exports, nonetheless, will be muted by an additional 6-percent tax on agricultural exports and the removal of 6 percent of the subsidy for manufactured exports. These changes probably were designed to keep the 1984 budget deficit within IMF targets. The tax, however, runs counter to the IMF's intention to reward farmers and stimulate production. [redacted]

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We believe the moves probably also were intended to show Argentina's bankers that the government is serious about addressing some of its major economic problems. [redacted] Buenos Aires is asking private banks for the \$5.5 billion needed to fund its IMF program. The IMF is scheduled to meet on the Argentine program in mid-December to formally approve a \$1.4 billion standby loan, but only if the foreign financing gap has been filled. We believe the Argentines may have to turn to the United States and other governments, as well as multilateral agencies, to meet its goal, because bankers continue to indicate reluctance to provide more than \$3-3.5 billion in support of the financial rescue program. [redacted]

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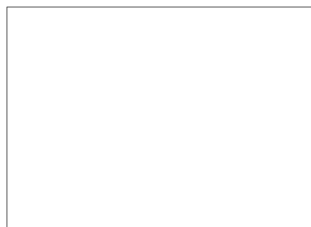
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*Kuwaiti Banks
Still Carrying
Bad Loans*



[Redacted] Kuwait's commercial banks are still counting \$500 million in loans made before the 1982 crash of the Suq al Manakh (the unofficial stock market) as assets—although they believe repayment is unlikely. [Redacted]

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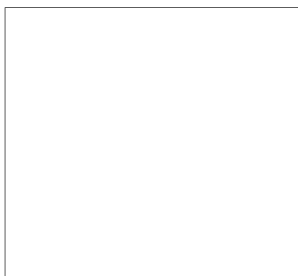
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[Redacted] Press reporting indicates that total nonperforming loans by Kuwait's six commercial banks could reach \$2.7 billion, exceeding their total shareholder equity of \$2.2 billion at the beginning of 1984. Although reluctant, the government would probably provide funds to a bank with serious liquidity problems to save it from insolvency. [Redacted]

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*Dominican Republic's
Financial Troubles
Deepen*



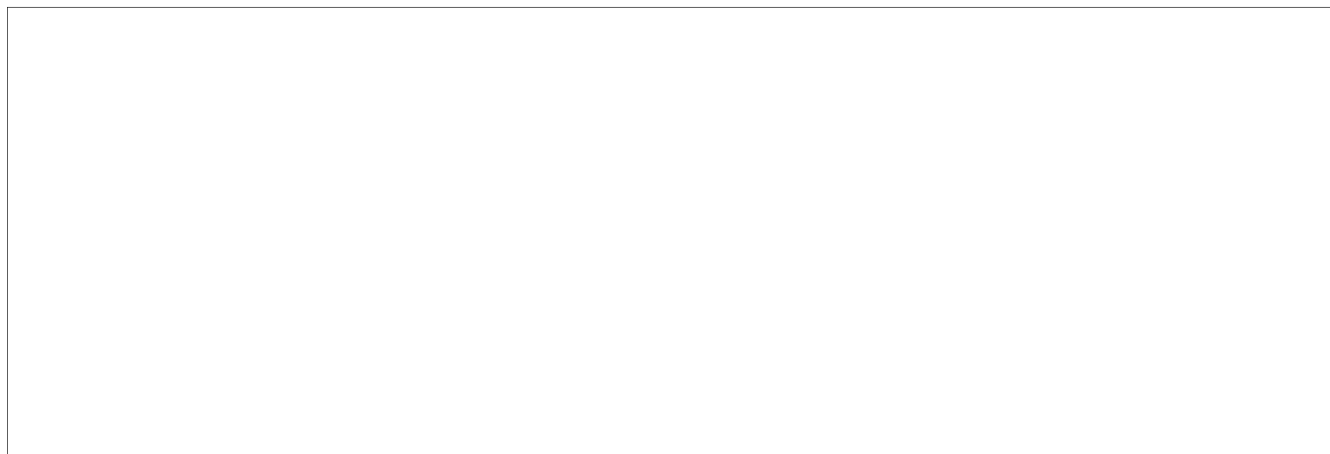
The Dominican Government estimates that debt repayments will exceed official reserves by \$750 million by yearend 1984 unless it can obtain debt relief. Reserves now total only about \$170 million. A total of \$885 million is due to official creditors, mainly Mexico and Venezuela, and \$35 million to commercial banks through the rest of this year. The government has proposed a 90-day suspension of commercial debt service payments while preparing a restructuring proposal to be presented to foreign bankers by 31 December. The government also is hoping to conclude an IMF agreement by December and a Paris Club rescheduling by March 1985. We believe the government's timetable may be overly optimistic. In the meantime, deteriorating economic and social conditions could prompt new outbreaks of domestic unrest. [Redacted]

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Global and Regional Developments



*Computerized
Countertrade Center
Established in London*



BATIS International Services has established a London-based countertrade information center for international traders. The company reportedly will be the first of its kind to computerize global information on bids and offers for barter, counterpurchase, and buy-back schemes. The aim is to link traders in industrialized countries with potential trading partners in countries with liquidity problems that require countertrade deals to finance imports. This

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9 November 1984

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effort to coordinate the growing number of countertrade brokers reflects increasing acceptance of barter by London's financial district. Countertrade, they claim, with its complicated deals involving cash and bartered goods, generally is not very profitable. Nevertheless, experts point to a British Department of Trade and Industry report that indicates that without countertrade close to \$4 billion in British exports might be lost. This has led the government, which officially opposes barter on the grounds that it distorts free trade, to present this option to British exporters to preserve markets abroad.

[redacted]

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***World Food
Problems Continue***

[redacted]

Widespread famine continues to afflict Sub-Saharan Africa, where food aid distribution problems are contributing to regional instability. Food shortages are especially severe in Ethiopia and Kenya, where cereal crops are down 45 percent this year. Widespread, though less severe, food shortages are occurring in the Andean countries, with Bolivia and Ecuador hardest hit. The current food shortage in Africa will be the focus of attention next week in Rome at the annual meeting of the UN's Food and Agriculture Organization (FAO). While regional food deficits are likely to remain a problem for some time to come, on a global basis world food supplies are plentiful this year.

[redacted] world food production will exceed consumption by 11 percent. [redacted]

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National Developments

Developed Countries

***Japanese Plan
for Future
Auto-Export Restraints***

The Japanese are already planning for what they view as an inevitable extension of the voluntary restraint agreement on automobile exports to the United States, [redacted] The Ministry of International Trade and Industry (MITI) will demand the quota be increased from 1.85 to 2 million units for the year beginning 1 April 1985, and Toyota,

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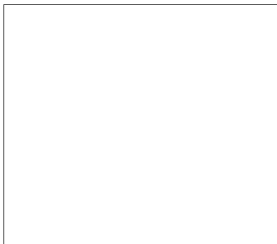
9 November 1984

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with the concurrence of MITI and the Japanese Automobile Manufacturers Association, has drawn up an allocation plan for a one-year extension. Although Toyota believes the smaller automobile makers will accept the plan because their relative market shares will increase, these firms may balk at continued curbs on their export sales. []

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*Keidanren Focusing
on Foreign Investors
in Japan*

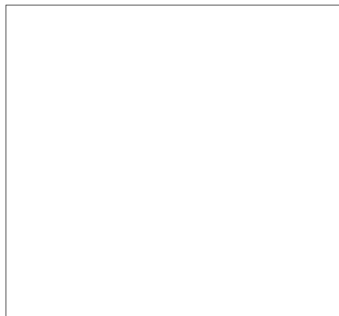


Keidanren, Japan's most influential business organization, has announced a new investment division to address problems of foreign companies operating in Japan, according to a recent press report. The new group will consist of representatives of 25 major, foreign-affiliated firms that currently belong to Keidanren. Non-Keidanren members will be permitted to attend the group's bimonthly meetings as observers. If the new division is taken seriously within Keidanren, foreign companies may have a channel for making their concerns heard in Japan's economic and regulatory policymaking process. Keidanren probably hopes that easing problems for foreign firms in Japan will help reduce barriers to Japanese overseas investment. []

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*New MITI
Research Program*



MITI has proposed a new program—the Industrial Technology Development Promotion Organization (ITDPO)—to promote cooperative research in advanced materials, biotechnology, and electronics. The program will identify research targets, assign projects among participating Japanese firms, and jointly fund basic research. MITI will also disseminate research results to program participants. ITDPO will recruit foreign researchers to assist in most projects. Planned funding will include research grants, tax cuts, and long-term loans at subsidized rates through the Japan Development Bank. While press sources report that the Finance Ministry is opposed on budget grounds, MITI is pushing hard and we believe that most of the program will be funded. []

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*More Competition
for NTT*



The Japanese Construction Ministry is supporting formation of another competitor to Nippon Telegraph and Telephone Public Corporation (NTT), according to the press. It is backing a consortium for the construction and maintenance of optical-fiber cables along major highways as a preliminary step to the formation of a new telecommunications firm. A joint venture led by Kyocera previously announced plans for a new telecommunications firm after the market is opened to competition in April by legislation expected to pass the Diet next month. The Ministry no doubt sees entry into telecommunications as a way to increase its influence and to gain revenues to offset budget cuts caused by Japan's tight fiscal situation. The Japanese National Railways, also considering use of its right-of-way for telecommunications lines, may be prodded by the Construction Ministry's plans. While NTT will continue to dominate Japanese telecommunications, the presence of more competitors may help foreign telecommunications equipment firms crack NTT's system of close relationships with Japanese companies. []

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9 November 1984

Secret***Portuguese Real
Wage Losses***

According to preliminary data, Lisbon's austerity program is severely pinching real wages, which fell for all sectors of the economy by 11 to 18 percent during the first quarter of 1984 compared with the same period last year. Lisbon is predicting a 12.5-percent average decline this year. Real disposable income, however, is cushioned by remittances from family members abroad, overtime work, earnings on the underground economy, and support from relatives in rural areas. After Lisbon's standby program ends early next year, pressure to boost wages almost certainly will grow, and, with elections in the fall, the Soares government might not resist. []

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***French Announce
Fifth-Generation
Computer Project***

France has decided to establish an independent fifth-generation computer research project—the Intelligent Machine Institute (IMI) at the Grenoble National Polytechnic Institute. Paris has provided an initial investment of \$4 million and plans a staff of 150 researchers by the end of 1985. Prospects for success in this independent effort are limited because the IMI project is seriously underfunded, and the French lack manpower and expertise in VLSI and related technologies. Given these drawbacks, we believe the French program may, in part, be an attempt to gain more control over the European Computer Research Center and the cooperative research projects under the European Community's Esprit program. []

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***Israeli
Wage-Price Freeze***

Israel's new national unity government, the Manufacturer's Association, and the Histadrut—the large trade union organization—ratified a "package deal" earlier this week that implements a three-month price freeze. Israeli workers will forgo up to one-third of the cost-of-living adjustment for the next two months, but will be partially compensated by a 5-percent income tax credit for three months after the freeze is lifted. According to US Embassy estimates, real wages will decline by 20 percent. The agreement buys some time for the government to come up with a more comprehensive economic program. It will have only a limited economic impact, however, unless the government implements and enforces budget cuts of at least \$1 billion. The value of the wage-price freeze will also be reduced if workers are compensated for the decline in real wages or if consumers use their ample savings to maintain living standards. []

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Less Developed Countries***Nigeria's Defiant
Economic Nationalism***

Nigeria probably will try to compensate partially for its recent cut in oil prices by increasing production above its new OPEC quota, but Head of State Buhari's government is unlikely to stem the country's economic slide. [] Nigeria's oil output has averaged about 1.6 million barrels per day in recent weeks, well above the quota of 1.45 million barrels per day granted by OPEC this week. The US Embassy estimates that, even if Lagos can export its increased output, Nigeria's lower price will cause oil revenues to fall \$4 billion short of Lagos's \$15 billion target this year. At the same time,

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9 November 1984

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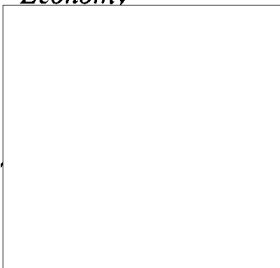
Nigeria has been falling behind on obligations of about \$3-4 billion due this year on \$15 billion in medium- and long-term debt. Lagos also is unlikely to be able to pay the \$750 million in interest due on its \$8-10 billion outstanding trade debt. The foreign exchange squeeze has forced Lagos to try to limit foreign purchases to about \$4.6 billion this year—half the already sharply reduced level of 1983. Shortages in imports and raw materials are causing most industries to operate at only 25 to 30 percent of capacity. []

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In Nigeria's most defiant reaction yet to IMF conditions, a spokesman of the regime last week rejected IMF help as destabilizing and announced a go-it-alone austerity program. According to the US Embassy, Lagos probably will continue to use stopgap financial measures such as restricting import licenses and selectively repaying lenders in attempts to regain access to short-term trade credits. Nigeria's bleak financial outlook and defiance of the IMF will continue to keep the regime under siege. The oil market is likely to remain weak for the next two to three years. Moreover, Lagos has failed to diversify its economy, which is heavily dependent on oil revenues, leaving no alternative income earner in sight. []

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*Lebanese Moves
To Shore Up
Economy*

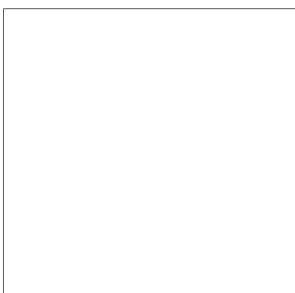


The precipitate fall of the Lebanese pound and burgeoning government debt have spurred the Lebanese Government to try to shore up the economy. On 3 November, Lebanese air and naval forces began enforcing a ban on the use of numerous illegal ports to halt the loss of import duties, Lebanon's most important source of revenue. Syrian troops reportedly helped close illegal ports in and around Tripoli. These ports had siphoned off an estimated \$400 million a year, about one-fourth of this year's budget. Lebanon's central bank has also issued new regulations to dampen speculation against the pound. Stringent reserve requirements have been imposed on commercial banks' foreign exchange holdings and on nonresident pound accounts; banks must report their foreign exchange positions daily; and restrictions have been placed on forward exchange transactions involving pounds that are not trade related. The government is also eliminating its subsidies on petroleum products and is trying to improve its collection of direct taxes and fees. []

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*Malawi's Progress
in IBRD Negotiations*



Malawi's negotiations with the World Bank and the IMF have been successful so far. A compromise has been reached on the divestment of Press Corporation, the country's largest parastatal, the major obstacle to disbursement of the final tranche of Malawi's second structural adjustment loan. An IMF team is in Malawi negotiating a third such loan for the April 1985–March 1986 budget year. Possible obstacles may be President Banda's decision to forgo debt rescheduling, which will mean a sharply higher debt service ratio, and Malawi's continuing difficulties in obtaining fuel, which will crimp export earnings. Malawi's risky decision to recommence regular debt payments probably stems from Banda's desire to demonstrate to his socialist neighbors that his Western-style economic policies have succeeded. []

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9 November 1984

Secret

*Libyan Urban
Sanitation Crumbling
Under Stress*

Libyan cities have been inundated by dirt and uncollected garbage since the government decision last spring to dismiss sanitation workers—primarily Tunisians and Turks—and require civilians to collect their own garbage and clean the streets. The popular disdain for such work and Libya's already poor sanitation system have compounded the trash problem and hastened the spread of related disease. Libya is urgently negotiating the purchase of 450 tons of rat poison to combat a serious rodent infestation in major urban centers. [redacted]

[redacted] plague has erupted in Tobruk and other cities as a result of the rat problem and that Soviet medical technicians have been called in to help. Qadhafi's opponents almost certainly will cite the waste problem as another example that his radical economic and social reforms have failed. [redacted]

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Thai Devaluation

Bangkok last week devalued the baht by 17 percent against the US dollar, surprising both the diplomatic and financial communities. The move is intended to reduce the large Thai trade deficit, but it almost certainly will push the inflation rate well above the current 4 percent. Although the Thai foreign payments position has improved recently, Bangkok probably acted to bolster longer term export competitiveness and to maintain the country's good international credit rating. The inflationary effect of the devaluation, however, may provoke large public demonstrations at a time when Prime Minister Prem is attempting to strengthen his political base after his recent illness. Prem was able to ride out the political turmoil following the 1981 devaluations, and chances are better than even that he can do so again. [redacted]

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*India Liberalizing
Computer Import
Policy*

India plans to liberalize its computer import policy and is looking increasingly to non-US suppliers, according to the Indian press. New Delhi will purchase an Elbrus, the USSR's most advanced scientific computer, and two other very large computers, in a deal linked to Soviet purchases of Indian electronic goods. We believe the press reports were inspired by Indian Government officials and that New Delhi is trying to elicit a more accommodating US position in forthcoming bilateral negotiations on technology transfer. The press reports note that the USSR is more willing to sell its latest technology than the United States, and they reaffirm that India will not violate reexport restrictions imposed by the United States or other Western suppliers. Indian interest in advanced technology is likely to continue under new Prime Minister Rayiv Gandhi, who emphasized in a December 1983 interview that India must not be left behind in the technological revolution in microelectronics and computers. [redacted]

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*Netherlands Antilles
Refinery Closure
Compounds Economic
Troubles*

Exxon has announced plans to close its Aruba oil refinery, the largest in the Netherlands Antilles, early next year after a yearlong effort to make the refinery profitable. Royal Dutch Shell, operator in Curacao of the other refinery in the six-island federation, has announced that it also will pull out unless costs can be cut. Reduced US oil demand and excess refining capacity

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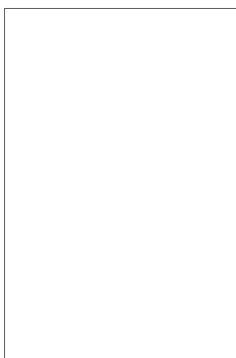
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9 November 1984

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have depressed sales of refined products, which account for 97 percent of Antillian export earnings. With other foreign exchange earners—tourism, ship repair, and offshore banking—already languishing, closure of even one refinery would be a major blow to the country's economy. A shutdown of both would add about 2,000 workers to the jobless ranks, pushing the unemployment rate to over 40 percent. Growing economic troubles are likely to generate unrest, particularly as the federation prepares for the separation of Aruba in early 1986. []

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Barbados's Economic Problems



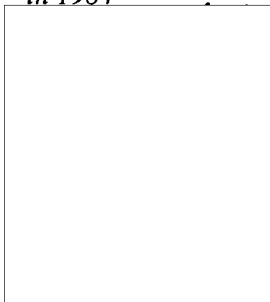
The Barbadian economy continues to falter because of a less-than-expected impact on exports of the economic recovery in the United States—its major market—and the Caribbean Basin Initiative (CBI), as well as a limited recovery in tourism. Formerly one of the Caribbean's strongest performers, Barbados is likely to register little economic growth in 1984. Excessive government regulation appears to be limiting the coattail effect of the US recovery and reducing the effectiveness of the CBI. Moreover, intraregional protectionism has hobbled exports of light manufactures, and high processing costs and low world prices are more than offsetting the 18-percent rise in sugar production this year. The economic slowdown has pushed the overall jobless rate to 18 percent—the highest since 1976. Falling exports have also prompted the government to borrow heavily at home and abroad on nonconcessional terms to continue funding its ambitious development plan. []

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Communist

Projected Soviet Economic Growth in 1984



Performance during the first nine months of 1984 indicates Soviet GNP growth will probably slip to between 1.5 and 2.5 percent this year, compared with 3 percent for 1983. Industrial growth through the first three quarters appears to be close to 3.5 percent, roughly equal to last year's. Estimates based on Soviet statistics indicate machinery has been the fastest growing sector of industry and consumer goods the slowest. Basic industrial materials have grown at slightly less than the industry average. Energy performance is mixed. Output of oil remains slightly below last year's production in the comparable period and could, for the first time, fall below the previous year's level. Coal output is also down from last year, but gas and electric power continue to register strong growth. Production of meat and milk may reach new records this year, but downturns in production of grain, potatoes, and sugar beets will hold overall agricultural output to roughly last year's level. Growth outside industry and agriculture appears to be continuing at about last year's rate. []

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Despite the setback in crop production, General Secretary Chernenko's regime can claim that the pace of improved industrial growth in 1983 under Andropov has been maintained. Trends in quarterly industrial production, however, suggest that the industrial recovery may be tapering off. Declining prospects for oil production are making the choice between domestic consumption and exports increasingly difficult. []

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*Background
to Agriculture Plenum*

A Soviet economist has told a US Embassy official that the recent party plenum resulted from the pressures, imposed by this year's poor harvest, to resolve disagreements over agricultural investment. The Politburo last spring merely reaffirmed earlier goals for land reclamation but apparently made little progress on a specific plan even though formulation of the next Five-Year Plan (1986-90) seemed well along. One major problem was Gosplan's opposition to increased irrigation as too expensive a means of increasing livestock feed supplies and disruptive to economywide investment plans. The economist insisted that the land improvement program announced at the plenum would not shift funds from other sectors but would be achieved by increasing the planned rate of growth of investment. Other Soviet officials have indicated that, although the investment increase may be small, the plenum dramatized the regime's commitment to land improvement. Even a small increase in investment for agriculture, however, with no corresponding reduction for other sectors, would signal a further retreat from the plans enunciated in the early 1980s to reduce the share of national income devoted to fixed capital investment. As a large share of investment for the 1986-90 plan is already ticketed for other parts of the food program and energy, additional investment for land improvement suggests that higher investment priorities for such key sectors as transport and civilian machinery are unlikely. []

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*CEMA Council
of Ministers Meeting*

The annual CEMA ministerial meeting held in Havana last week apparently sidestepped pressing economic issues. The communique echoed the final statements of the CEMA summit held in Moscow last June, suggesting little headway was made on the immediate tasks confronting the organization. Soviet press accounts say delegates approved cooperation agreements in the areas of energy and raw materials, electronics, microprocessing, and robotics. The East Europeans were probably relieved that Council of Ministers Chairman Tikhonov did not repeat earlier warnings that delivery of energy and raw materials would be contingent on economic conditions in the USSR. The USSR also signed a bilateral economic cooperation program with Cuba through the year 2000, similar to those it had signed earlier with Poland and East Germany. The communique reiterated the Soviet call to move forward with CEMA participation in major projects of direct benefit to the Soviets: an iron ore plant at Krivorizhye, a new gas pipeline to Eastern Europe, and the development of oil and gas deposits at Ashtrakhon'. The terms of East European participation in the gas pipeline remain to be worked out in bilateral negotiations. The communique cited CEMA interest in developing mineral deposits in Poland, Czechoslovakia, Cuba, Mongolia, and Vietnam. []

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*Record East European
Grain Harvest*

A record grain harvest this year in Eastern Europe will help the regimes to continue improving their hard currency trade balances, but East European consumers are likely to see only a modest increase in supplies of quality foods—especially meat. Grain production this year is estimated at a record 104 million tons or more, the third consecutive bumper crop. Poland and East Germany already have announced record crops, and Yugoslavia is expected to

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9 November 1984

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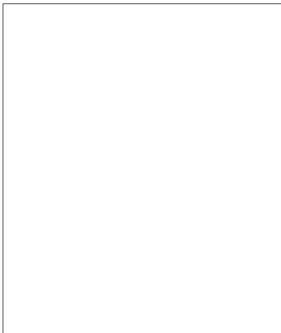
do likewise. The Hungarian crop evidently is its second largest ever, and Czechoslovakia's is expected to be above average. Bulgaria probably will produce an average crop, while Romania appears headed for its second consecutive below-average harvest. [redacted]

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Another good harvest and continuing efforts to reduce hard currency debt are likely to hold grain imports to between 7.1 million and 8.5 million tons, slightly lower than last year. Grain exports, including those for hard currency, are expected to increase from last year's 4.7 million tons to between 5.0 million and 5.6 million tons. US grain sales to Eastern Europe probably will remain depressed, because Canada and Western Europe are offering more favorable credit terms and prices. Food supplies—particularly meat—will remain tightest in Poland and Romania. Consumers in the other countries, however, still will face spot shortages and price hikes. [redacted]

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*Worker Concern
About Polish
Austerity Policies*



Workers are voicing concern that proposed austerity policies for 1985 would lower their standard of living. A draft of the economic plan calls for a freezing of real wages and only slight increases in food supplies and housing. The government also is reportedly sounding out worker reaction to the elimination of work-free Saturdays—a right won by Solidarity in 1981. Furthermore, officials have warned in the press about possible large increases in prices of luxury and nonessential goods over the next several months. [redacted]

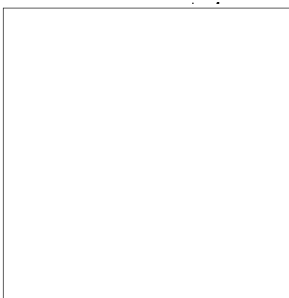
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Warsaw probably is suggesting these austerity measures in part to impress Western financial officials. As in the past, workers probably will protest any cut in living standards, and Warsaw in turn will give in. Despite a similar plan this year, the government ignored the guidelines and permitted real wages to rise 8 percent in the first six months of 1984 as compared with the same period last year. A repeat of such a move next year would further impede Warsaw's ability to deal with its longstanding economic and financial problems. [redacted]

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*China Faces
Power Emergency*



The 30 October *China Daily* quotes an electric power official as saying that China faces a severe electric power shortage this winter because of water shortages for hydroelectric production and coal transport problems. Major industrial areas in Shanghai and East China may be hardest hit. Power production in the last quarter of this year is now expected to fall 4.1 percent compared with the same period in 1983, after 7-percent growth over the first three quarters. While electricity production for 1984 would still total 366 billion kilowatthours (kWh), slightly above the conservative target of 360 billion kWh, growth of only 4.2 percent over 1983 contrasts sharply with the 8.1-percent average annual growth rate since 1976. China's power supplies have been chronically inadequate in recent years; but the front page treatment of this potential shortage highlights the severity of the problem. [redacted]

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OPEC and the Oil Market: Not Out of the Woods Yet

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OPEC's decision at its emergency meeting last week to defend the \$29 per barrel benchmark price by reducing production quotas is at best a short-term solution to the more fundamental issues confronting the organization. The serious financial pressures faced by several members have made it increasingly difficult over the last year or so for the organization to meet market requirements without undermining prices. Many members have attempted to increase their market share through substantial price discounts or, in the case of Nigeria, by openly reducing prices. If OPEC members comply with the terms of their most recent agreement, oil prices should firm this winter. OPEC continues to face a very slow rate of growth in the demand for its oil, however, and must either find a way to strengthen faltering discipline or face further reductions in oil prices.

Market Setting

Underlying oil market weakness—because of the steep fall in oil consumption in recent years and substantial excess production capacity—was exacerbated in midyear when substantial overproduction by OPEC members caused spot oil prices to fall sharply. Spot oil prices remained weak well into the fall—even though OPEC crude production fell to 16 million barrels per day (b/d) in September—because a number of countries were offering sizable price discounts. Inability of North Sea oil producers to hold onto contract buyers led to reductions in official North Sea prices—first in Norway, then in the United Kingdom. Because Nigerian crudes compete directly against North Sea crudes, Lagos quickly followed with an even larger cut in its official oil prices. The timing of the most recent price crisis caught OPEC members and many industry analysts by surprise because of the relatively low level of OPEC output in recent months, data suggesting that oil inventories were at a

moderately low level, and the expectation of a seasonal increase in oil demand. Nevertheless, OPEC moved quickly to confront the challenge to its price structure by scheduling an emergency meeting for 29 October in Geneva.

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The OPEC Accord

OPEC last week agreed to reduce temporarily its 17.5-million-b/d output ceiling by 1.5 million b/d to defend the benchmark price. This decision was strongly advocated by Saudi Oil Minister Yamani but came only after protracted and sometimes difficult negotiations:

- Saudi Arabia—OPEC's swing producer—agreed to a 13-percent reduction in its implicit quota of 5 million b/d, but Riyadh's output already is 300,000 b/d under its new production limit. According to Yamani, however, Riyadh is willing to make additional production cuts if necessary to prop up prices. 25X1
- Kuwait and the UAE together agreed to absorb an additional 20 percent of the 1.5-million-b/d ceiling cut.
- Venezuela, Indonesia, Libya, and Iran agreed to reduce their quotas by 100,000 b/d or more. Algeria, Qatar, Ecuador, and Gabon agreed to smaller cuts.
- Because of their serious financial problems, Iraq and Nigeria were exempted from lowering their production quotas even though both are producing well above prescribed levels. Nigeria was allowed to retain its special quota of 1.45 million

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DI IEEW 84-045
9 November 1984

Secret

OPEC Production Cuts

Thousand barrels per day

	Production Quotas			October Production ^a
	Old Quota	New Quota	Reduction	
Total	17,500	16,000	1,500	16,745
Algeria	725	663	62	700
Ecuador	200	183	17	240
Gabon	150	137	13	165
Indonesia	1,300	1,189	111	1,400
Iran	2,400	2,300	100	1,900
Iraq	1,200	1,200	0	1,300
Kuwait	1,050	900	150	900
Libya	1,100	990	110	1,000
Neutral Zone ^b				400
Nigeria	1,300	1,300	0	1,440
Qatar	300	280	20	400
Saudi Arabia ^c	5,000	4,353	647	4,000
UAE	1,100	950	150	1,100
Venezuela	1,675	1,555	120	1,800

^a Preliminary.^b Neutral Zone production is shared equally between Saudi Arabia and Kuwait and is included in each country's production quota.^c Saudi Arabia has no formal quota; it acts as swing producer to meet market requirements.

b/d—150,000 b/d above its original ceiling—granted by OPEC in July. Nigeria also retained its price cut of \$2 per barrel, which helped precipitate the latest crisis.

To justify the special treatment accorded Nigeria, some OPEC ministers, including Yamani, told the press that Lagos would restore prices to the official level of \$30 per barrel when spot prices rose and that Lagos would not increase output above the 1.45-million-b/d level. Lagos publicly remains non-committal about future actions, but is likely to keep production high to bolster sagging oil revenues.

OPEC's agreement was publicly supported by two non-OPEC countries—Mexico and Egypt. Mexico announced a 100,000-b/d cut in exports. Mexican exports normally drop slightly as winter approaches

because of interruptions in tanker-loading operations. Egypt reportedly agreed to reduce production by 30,000 b/d. According to US Embassy reporting, however, Egypt probably will not reduce output.

The quota reductions are largely symbolic and, because we estimate that OPEC's crude output has been averaging about 16 million b/d in recent months, are merely a ratification of market-imposed levels. By calling for a reduction in quotas rather than in actual output, the accord may not result in any cut in production if members currently producing above their quotas do not reduce output. OPEC's new accord could be quickly undermined because the new official quotas actually allow for a rise in output by those members currently producing at low levels.

Secret

9 November 1984

16

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Non-Communist Oil Demand and Supply ^a*Million barrels per day*

	1983	1984				1985	
		First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total	
Consumption	44.1	46.7	44.0	44.3	46.1	45.3	45.8
Supply	43.1	44.7	45.0	43.6	45.3 to 45.8	44.7	45.8
Non-OPEC	24.5	25.6	25.6	25.7	25.8	25.7	26.1
OPEC	18.5	19.1	19.4	17.9	19.5 to 20.0	19.0	19.7
Inventory change	-1.0	-2.0	1.0	-0.7	-0.8 to -0.3	-0.6	0

^a Figures exclude refinery gain but include about 1 million b/d of natural gas liquids. Data are preliminary through the third quarter of 1984; fourth-quarter 1984 and 1985 figures are projected.

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Short-Term Market Situation

We expect non-Communist oil consumption of about 46 million b/d in the fourth quarter of this year, assuming normal winter weather.¹ On the basis of this consumption forecast and a non-OPEC production estimate of 25.8 million b/d, we expect demand for OPEC oil—including natural gas liquids—to average about 20 million b/d for the quarter in the absence of any significant drawdown of oil stocks. This forecast is generally consistent with industry projections that we have reviewed. Decisions by companies to meet a greater portion of seasonal requirements from inventories could lower the projected fourth-quarter OPEC production estimate—perhaps by 500,000 b/d. A sizable inventory reduction in the next few months, however, would boost OPEC production substantially in the first quarter of 1985 because inventory levels probably would be insufficient to allow a normal first-quarter stock drawdown.

Industry decisions about using inventories in the next few weeks probably will depend in large part on how seriously the market views OPEC's commitment to its new accord. Oil companies are likely to move only cautiously to increase liftings as they

monitor OPEC actions on prices and production. Because we estimate that primary oil stocks on land were about 4 billion barrels at the end of the third quarter—or about 87 days of forward consumption compared with a more typical 90 days—we believe companies will hesitate to reduce stocks much further as the winter heating season approaches. As a result, OPEC probably must stick with its 16-million-b/d production ceiling for only the next few weeks to defend the current price structure in the immediate term. Moreover, the Saudis have sufficient flexibility to reduce their output further to compensate for some cheating by other members.

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Movements in spot oil prices are a barometer of market reaction. Following the price cuts in mid-October by the United Kingdom and Nigeria, spot prices for Arab Light crude—the OPEC benchmark—fell about \$1 per barrel and spot prices for North Sea crudes dropped about \$2 per barrel. Spot prices for these crudes have increased since OPEC announced its decision to defend the benchmark price, however, and were less than \$1 below official levels late last week. Despite the outlook for an increase in demand for OPEC oil and the slight

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¹ Figures exclude refinery gain.

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firming in spot oil prices, a number of difficult issues remain for OPEC, some of which must be addressed within the next few weeks. []

The Differential Issue

The ministers did not address the basic problem in the organization's pricing structure—the gap between light and heavy crude oil prices—which many analysts consider the most serious threat to OPEC's cohesion. OPEC instead deferred discussion of price differentials, appointing a committee to consider various restructuring schemes. The committee—chaired by Yamani and including the oil ministers of Libya and the UAE—is expected to present its recommendations at OPEC's next ministerial meeting scheduled for 19 December. The upgrading of refineries in recent years has increased the attractiveness of heavy crudes relative to light crudes and caused the present differential of as much as \$3 per barrel to become outdated. Some studies indicate that a reasonable price differential for Arab Light and Arab Heavy crudes is about \$1 to \$1.50 per barrel. []

OPEC could alter the present price structure by raising heavy crude prices—as some members have suggested—lowering light crude prices, or some combination of these two. This is an extremely complex problem for OPEC because differentials between crudes change seasonally. Moreover, differentials vary in major market areas depending on refinery configuration and the consumption pattern for oil products. []

[] heavy/light differentials have been strongly influenced this year by the increased demand for heavy fuel oil caused by the lengthy coal strike in the United Kingdom. We doubt that these factors can be adequately weighed in the short time available to the special committee before OPEC's next meeting. We expect all members to consider carefully any proposal for a change in the present differentials because these price differences determine the relative attractiveness of each country's crude and influence production levels. []

Production and Price Pressures

Many members have been unwilling to have Saudi Arabia play the swing producer when production is increasing. A struggle between members for market share this winter could again result in price discounts and overproduction that could undermine the defense of the current price structure. Indeed, earlier this year several OPEC countries were advocating a reapportioning of production quotas to distribute the expected increase in seasonal demand. []

Nigeria's refusal to rescind its \$2 per barrel price cut also has complicated the price issue for OPEC because a low Nigerian price puts additional pressure on North Sea producers. If buyers delay liftings in the next several weeks—threatening UK production levels—London could be forced to further reduce prices. Algeria cut the price of its condensate by 50 cents per barrel. Although condensate prices are not subject to OPEC pricing guidelines, the move will put additional downward pressure on prices. In North America, Canadian light crude oil prices were reduced by about \$1.35 per barrel, and several integrated US companies lowered posted prices after the OPEC meeting. Spot oil prices probably will have to firm significantly to encourage producers in these areas to increase prices in the next month or so. We believe OPEC can muddle through the next several weeks because of the rise in seasonal demand. This could cause the organization to become optimistic that it has overcome the threat to its price structure, but the outlook for the oil market in 1985 indicates OPEC cohesion and discipline will continue to be tested. []

The Outlook for 1985

According to several industry projections, non-Communist oil consumption will increase only about 1 percent next year. We expect demand for OPEC oil—assuming no net change for the year in

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9 November 1984

Secret

oil inventories—to approximate 19.7 million b/d, including natural gas liquids, an increase of 700,000 b/d from expected production this year. This annual production figure does not take into account the substantial swings in OPEC production needed to accommodate seasonal demand variation. If this expected increase in the demand for OPEC oil materializes, it will again raise the question of which members should be allocated increased production quotas. []

OPEC—What Options?

As seasonal demand for OPEC oil subsides, the organization's underlying problems will again be unmasked, reinforcing trends that are steadily undermining OPEC's effectiveness in enforcing its pricing and production decisions. Limited growth in oil demand, rising non-OPEC production, misalignment of price differentials, and the growing volume of competitively priced product exports indicate additional strains to OPEC cohesion in the future. Because most members continue to discount prices and merely pay lipservice to official prices, OPEC's options for handling these pressures are relatively limited. []

Restrain Production. OPEC could choose to continue to try to restrain production to meet market requirements but the organization has yet to demonstrate success. Saudi Arabia probably would be called upon to absorb much of the production slack but, although Riyadh maintains the flexibility to do so, may be willing only if it gets the cooperation of all OPEC members. Moreover, Iran could prove a stumblingblock if it refuses to restrain output because of its declining economy. Financially strapped members like Nigeria, Venezuela, and Indonesia also would be hard pressed to accept continued depressed revenue levels. []

Cut Prices. OPEC, led by Saudi Arabia, could decide that oil prices are too high to allow for a reasonable increase in oil demand over the longer term. A decision to further reduce official oil prices probably would face considerable opposition from OPEC members who would suffer an immediate

decline in revenues and who are far less concerned about ensuring a viable oil market in the late 1990s and beyond. An oil price cut also would raise the difficult issue of the optimal size of the reduction. A reduction to \$22 per barrel would return real prices to about the 1974 level, while a cut of about \$4 per barrel would put real prices near the 1979 level. In our judgment, this brackets the range of cuts that is likely to be taken if Saudi Arabia determines another reduction in official prices is necessary. []

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We believe Riyadh would advocate a price cut if the Saudis view this as necessary to protect their longer term market interests or if other OPEC members refuse to share the burden of defending the current benchmark. On the face of it, events leading into the recent emergency meeting indicate that Yamani strongly supports maintenance of the current benchmark price, but Riyadh simply may not have been willing to cut prices now. If reports that Yamani—OPEC's most knowledgeable minister—may soon resign prove accurate, we believe the organization's ability to formulate and implement strategy to avoid price reductions would further diminish, increasing the likelihood of a price cut next year. []

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**Brazil: A Critical
Role for Exports**

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Brazil is counting heavily on rapid export growth to meet its foreign debt obligations and launch a recovery from its prolonged and socially unsettling economic recession. We estimate that Brazilian efforts to promote a resurgence in exports—most notably through currency devaluations—will boost export earnings in 1984 by at least 20 percent over last year. Brazil's prospects for exporting its way out of its debt crisis during the remainder of the 1980s also appear good but depend on a healthy world economy and a continuing commitment by Brazil's new civilian government to implement prudent export policies.

Strengthening Export Promotion

The Brazilian Government undertook several policy reforms starting in 1983 to revive rapid export growth as the way out of its debt crisis. To eliminate the overvaluation of its currency, Brasilia devalued the cruzeiro 23 percent against the US dollar in February 1983. Thereafter, it depreciated the value of the cruzeiro in line with domestic inflation in a series of mini-devaluations. These actions reduced the cruzeiro's effective real rate of exchange against a basket of trading partner currencies nearly 20 percent in 1983, improving the price competitiveness of Brazilian goods worldwide.

According to press and US Embassy reporting, Brasilia also has increasingly used tax incentives to boost exports. In March 1983, the administration expanded the number of export-related goods exempted from the country's two main value-added taxes. Besides the manufactured exports previously exempted, manufactured inputs for these products became eligible as well. Brasilia expanded the use of import tax relief and duty exemptions over the past year—under the Fiscal Benefits for Special Export Programs—for certain capital equipment

used in the production of export goods. While the government has had to cut subsidized credits for the export sector because of austerity commitments to the IMF, it is attempting to replace this long-standing program with a government-supported private bank financing system.

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Public and private firms have adopted more aggressive sales promotion techniques to expand their foreign markets, according to the US Embassy and the press. For example, delegations from Siderbras—the government-owned steel company—have stepped up marketing efforts worldwide for Brazilian steel products. Also, Interbras, a trading-company subsidiary of the state oil company Petrobras, uses the leverage of its parent extensively to secure pledges from foreign oil suppliers to purchase large amounts of Brazilian goods and services.

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Recovery Under Way

Brazilian trade statistics indicate that the government's policy initiatives and the gradual economic recovery of the industrial countries reversed the export decline in mid-1983. An 8-percent rise in exports, combined with a 21-percent cut in imports, enabled Brazil to exceed its IMF program target with a \$6.5 billion trade surplus last year. We project that Brazilian exports in 1984 will total \$26.5 billion, more than a 20-percent increase over the 1983 level. With imports still flat, this impressive export performance would produce a record \$11.5 billion trade surplus—enough to cover net interest obligations and to eliminate need of additional foreign borrowing—while still permitting a 15-percent rise in nonoil imports. In addition, Brazilian data indicate that this export growth is

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DI IEEW 84-045
9 November 1984

Secret

Brazil: Composition of Exports

	1964		1974		1981		1983	
	Million US \$ ^a	Percent	Million US \$ ^a	Percent	Million US \$ ^a	Percent	Million US \$ ^a	Percent
Total	1,430	100.0	7,950	100.0	23,295	100.0	21,900	100.0
Soybean and products	5	0.2	890	11.2	3,190	13.7	2,565	11.7
Coffee	760	53.1	980	12.3	1,760	7.6	2,325	10.6
Iron and steel products	15	1.0	165	2.1	1,125	4.8	1,670	7.6
Iron ore	80	5.6	570	7.2	1,735	7.5	1,520	6.9
Transport equipment	10	0.5	185	2.3	2,065	8.9	1,445	6.6
Boilers, mechanical machinery	5	0.5	150	1.9	1,545	6.6	1,095	5.0
Footwear	NEGL	NEGL	120	1.5	585	2.5	715	3.3
Orange juice	NEGL	0.1	60	0.7	660	2.8	610	2.8
Beef	15	1.2	110	1.4	420	1.8	515	2.4
Sugar	35	2.3	1,320	16.6	1,060	4.6	515	2.4
Organic chemical products	NA	NA	NA	NA	425	1.8	515	2.3
Petroleum fuel oils	5	0.2	35	0.4	365	1.6	475	2.2
Tobacco	30	2.0	100	1.2	355	1.5	460	2.1
Electrical machinery and appliances	NEGL	0.1	185	2.3	565	2.4	440	2.0
Other	475	33.1	3,080	38.7	7,435	31.9	7,035	32.1

^a Components rounded to the nearest 5.

supporting a narrowly based industrial recovery in 1984. []

A relatively small group of countries has accounted for the bulk of Brazil's export expansion since early 1983. By far the most important has been the United States, which alone absorbed over half of Brazil's export growth last year and is taking another large share this year. Other important purchasers have been Japan and the oil-exporting countries of the Middle East and Africa. []

The recent resurgence has been almost entirely attributable to increased sales of industrial goods, the new bulwark of Brazilian exports. Such sales grew 14 percent in 1983 and a booming 39 percent in the first eight months of 1984. A wide range of

these products have shared in the export recovery, with the sharpest gains in steel, footwear, chemicals and plastics, frozen orange juice, and automobile engines. []

Challenges Ahead

With Brazil's imports now pared to only 5 percent of GDP, we believe that the entire burden of generating the trade surpluses required to finance heavy debt payments will fall to export expansion. Although some small additional import substitution is still possible in the extractive industries such as oil and copper, it will be more than offset by

Secret

9 November 1984

Secret

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requirements for more industrial material and machinery imports as Brazilian economic growth accelerates. []

To sustain export increases, Brazil must surmount some sizable challenges. Prospects for softer import demand in the United States, combined with pressures to reduce its \$100 billion current account deficit, probably will temper increases in Brazilian exports to this market. The financial press already indicates mounting pressures from US business and labor groups to limit access for some key Brazilian exports, most notably steel. Persistent financial problems and depressed economic conditions in Latin America and Africa are likely to forestall appreciably higher sales there over the next few years. Brazil probably will be unable to expand substantially sales to the USSR and Eastern Europe because of their dissatisfaction with the existing bilateral trade deficits, according to US Embassy reporting. []

Brazilian export growth will have to depend heavily on exports of manufactured goods. Judging from most government and private commodity price projections, Brazil's export drive will not get major help from its primary product sectors. Worldwide oversupply in a number of agricultural commodities—including coffee, cocoa, and sugar—will inhibit major improvement in world prices for these goods for some time. []

In addition, the installation of a new civilian government in March 1985 probably will encourage a more vigorous and contentious economic policy debate. Emboldened by new opportunities to influence public policy, we expect a number of businessmen, academics, and politicians to advocate a shift to a more domestic growth strategy at the expense of export-oriented policies. Advocates of such a strategy feel the IMF stabilization program has not effectively reduced inflation, has incurred intolerable social costs through unemployment and depressed incomes, and has transferred much too great a share of national resources abroad. Although we judge that this argument has been rejected by most Brazilians of authority, it could gain increased support if the economy does not show sufficiently strong growth. []

Near-Term Prospects

On the basis of US Embassy reporting, we judge that whichever civilian government is elected in January—either government party nominee Paulo Maluf or opposition candidate Tancredo Neves—it will adhere to the broad economic policy guidelines of the current regime. The candidates are promising to be more responsive to swelling popular pressures for improved economic conditions and probably will ease some elements of the austerity package, such as wage controls. Both, however, are widely reputed to be pragmatic on economic issues and will want to avoid radical policy changes and a break with the IMF. Faced with a projected \$12 billion in net interest payments for 1985, we expect the new government to continue to adjust exchange rates in line with domestic inflation, to sustain anti-inflationary fiscal policies, to oppose excessive wage increases, and to provide tax and financial incentives to exporters. [] 25X1

We believe that these policies and expected favorable world economic conditions will permit Brazil—barring a setback in agriculture—to record another strong export performance in 1985. In our view, Brasilia probably will boost exports some 10 percent to \$29 billion next year, supported largely by continued recovery in many of the industrialized countries and some revival of demand in the Third World. This would permit Brazil to achieve a \$12.5 billion trade surplus in 1985, substantially reduce new foreign financing needs, and facilitate a return to economic growth. A surplus of this magnitude would substantially exceed Brazil's net interest payments and—with principal repayments probably rescheduled—might prompt the government to limit its requests for new money to less than a third of the \$6.5 billion raised this year. As in 1984, the exports also would prop up Brazil's industrial plant utilization despite sluggish domestic demand and stimulate increased investment. Numerous economists inside and outside of Brazil expect that these trends probably will engender a rise in national output of at least 3 percent in 1985. [] 25X1

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Secret

9 November 1984

Secret

Brazil: Projected Export Requirements *Billion US \$*

	1985	1986	1987	1988	1989
Current account balance	-2.5	-1.0	0	0.5	1.0
Services balance ^a	-15.0	-15.5	-16.0	-16.0	-15.5
Trade balance	12.5	14.5	16.0	16.5	16.5
Oil imports ^b	5.5	6.0	6.7	7.3	8.1
Nonoil imports ^c	11.0	13.5	14.9	16.6	18.4
Required exports	29.0	34.0	37.6	40.4	43.0

^a The services balance is influenced predominantly by net interest payments, which rise through 1987, stabilize in 1988, and begin to fall in 1989.

^b Energy imports drop in 1985 as a result of continued increases in domestic oil production. Thereafter, we assume a leveling off of production, constant demand for imports, and moderate annual price increases.

^c In 1986, nonoil imports assume a value equal to 4.5 percent of expected GDP. Although slightly below ratios of the 1970s ranging from 4.6 to 5.0 percent, the 1986 relationship represents a substantial increase from the recession years of 1981-84. Thereafter, imports show an income elasticity of 1.0 for domestic growth—projected at 4 percent annually in 1985-87 and 5 percent annually in 1988 and 1989—adjusted for a projected average annual inflation rate of 6 percent. In 1988, an additional small increase reflects a 3.0 elasticity for the change in the growth rate.

Beyond 1985

Through this decade, we believe it is plausible that Brazil will be able to generate the export growth to overcome its debt payments difficulties while maintaining acceptable domestic economic growth.

we believe the key foreign payments stabilization task is elimination of the current account deficit within three years. By accomplishing this task, Brazil can begin to repay its principal with moderate new borrowings and to level off its overall outstanding foreign debt. We believe export earnings must rise at an annual rate of more than 10 percent if the government is to balance the country's current account by 1987 and achieve real GDP growth of 4 to 5 percent.

In our judgment, Brazil will be a competitive exporter as long as it continues its aggressive currency devaluations and restraints on wage in-

Brazil: Export Forecasts *Billion US \$*

	1984	1985	1986	1987	1988	1989
Data Resources	25.2	27.6	29.8	32.4	35.3	38.9
Chase Econometrics	26.8	28.9	31.5	34.3	38.0	42.7
Evans Economics	25.7	29.9	33.1	36.5	40.3	NA
Wharton	26.4	29.1	30.9	34.4	38.5	42.5
CIA	26.0	28.6	32.0	35.9	40.3	45.4

creases. Our simulation model shows—and major econometric forecasting services agree—that Brazil could sustain annual export growth rates averaging substantially more than 10 percent, assuming average annual world economic growth of at least 3 percent and no major shocks to the world economy. Manufactured goods, particularly transportation equipment, metals, and machinery, will probably lead the export advance. For example, the recent inauguration of production of world cars and trucks—such as the Ford Escort now produced mainly in Brazil—signals a major increase in auto exports to industrialized as well as developing country markets. Other consumer items that have yet to penetrate foreign markets in significant amounts, ranging from handicrafts to high-technology products, will probably make further major contributions. The startup of large mining projects in the Amazon is expected to yield considerable increases in exports of iron ore, manganese, and bauxite later in the decade.

Implications for the United States

Public statements suggest that Brasilia officials recognize the vital US role in absorbing manufactured exports in 1983 and 1984. Exports to the United States rose 25 percent in 1983, contributing to a \$2.6 billion bilateral trade surplus, and probably will rise by one-third this year. Driven by the need to service their debt, the Brazilians have been

Secret

9 November 1984

Secret

An Unfavorable Alternative

Despite our cautious optimism, we see some external and domestic risks for Brazil. Another substantial downturn in foreign demand beginning in 1985 or 1986 and lasting two years could slash the annual rate of growth of Brazilian exports in 1985-89. Domestically, persistent high inflation and low growth reinforced by sagging foreign demand might prompt the next civilian president to abandon strict austerity. To combat inflation, for example, the government could slow the pace of cruzeiro devaluations or increase export taxes to contain budget deficits. To spur growth, it might stimulate domestic demand and raise wages. Any of these measures clearly would undercut the goal of facilitating export growth. []

A combination of adverse international and domestic factors could cause a substantial fall in export earnings. Then, Brazil would not generate enough foreign exchange to fulfill its debt commitments, bank creditors would balk at requests for new loans, and Brazil's financial position would unravel badly. Under such conditions, we believe only a major debt relief program—perhaps extending over 20 years and involving some form of interest capitalization—would keep Brazil afloat financially and in good standing with the international trading community. []

disturbed by signs of emerging protectionist trends in the United States. US countervailing duties on carbon steel exports caused indignation, and some Brazilian officials even threatened retaliation. According to the US Embassy, potential US actions against Brazilian exports of textiles, shoes, alcohol, tobacco, poultry, and soybeans could cause additional frictions. []

As Brasilia intensifies its export drive, we believe it will continue to offer greater inducements to foreign firms to establish export operations in Brazil. More US firms may find that Brazil—especially if the next government maintains prudent exchange rate, wage, and fiscal policies—will become an

Brazil's Exports in 1984

We believe the following products will register large gains this year:

- *Orange juice exports will expand about \$500 million from last year to \$1.1 billion. Sharply higher prices resulting from the frost-induced devastation to the US orange crop have spurred the advance.*
- *Transportation equipment sales will rise more than \$400 million to about \$1.8 billion. Brazilian subsidiaries of foreign automakers are substantially increasing their exports of cars, trucks, engines, and vehicle parts to offset the impact of contracting domestic markets. The Brazilian financial press also reports sizable increases in sales of small aircraft abroad.* 25X1
- *Coffee exports will expand some \$400 million to \$2.7 billion. Brazilian sales will benefit both from a 10-percent average higher price this year and sharply increased sales to nonmembers of the International Coffee Agreement.*
- *Footwear exports will reach \$1 billion, some \$300 million more than in 1983. Most of the increased sales will occur in the United States, where a recent International Trade Commission (ITC) ruling rejected appeals by the US shoe-making industry for protectionist measures.* 25X1

increasingly attractive export production base, especially for sales to the Third World. Insofar as they contribute to stronger finances and economic growth, export successes also will make Brazil considerably more appealing to US and foreign firms that wish to make new investments to produce for local markets. [] 25X1

A failure to expand exports rapidly probably would hurt the financial positions of many US creditors. US banks, which hold nearly one-quarter of Brazil's \$100 billion in foreign debt, are extremely vulnerable to the debt-servicing disruption that

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almost certainly would follow any serious setback in Brazil's efforts to earn foreign exchange. [REDACTED]

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Brazil's export drive will have broader ramifications. Many other major debtor countries in Latin America and elsewhere are being urged by their creditors to strengthen their debt service capabilities through enlarged exports. To some extent, Brazilian export gains will come at the expense of other debtors who are not as well positioned to sell abroad. The situation would only be compounded if Western economic growth were to sputter in the years ahead. [REDACTED]

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Secret

9 November 1984

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Next 5 Page(s) In Document Denied

Secret

Saudi Arabia: Petrochemical Exports Assault Glutted Market

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Saudi Arabia's expanding petrochemical exports are starting to generate trade frictions with industrial countries, particularly in Western Europe. We believe trade problems will mount as low-cost Saudi petrochemicals flood the glutted global petrochemical market by the end of 1985. Although the soft oil market precludes Saudi manipulation of access to crude oil as a petrochemical marketing lever, tighter oil supplies in the future would strengthen the Saudi hand.

What Saudi Arabia Will Be Producing

Saudi Arabia's petrochemical investment program has been a major success in its larger industrialization effort. Saudi Arabia's capacity to produce basic petrochemicals and petrochemical products is scheduled to reach 7 million metric tons annually by the end of 1986. Production will come from capital-intensive, state-of-the-art facilities enjoying major economies of scale. The facilities concentrated in the new industrial city of Jubail on the Persian Gulf will give Saudi Arabia 7 percent of the methanol and 3 percent of the ethylene capacity worldwide.

The projects are mostly on schedule, and contractors have not experienced the payment delays that have arisen in other construction projects in the kingdom. The large investments and prompt payments reflect the high priority that the Saudi Government places on diversification from crude oil exports to products derived from oil or gas. Saudi Arabia and its foreign partners in the petrochemical industry will have invested at least \$11 billion. In addition, the cost of the Saudi gas gathering system is about \$15 billion, one-third of which can be counted as direct support to the petrochemical industry.

Economies of Scale in Petrochemical Production

The most efficient location for a basic petrochemicals facility is adjacent to an oil refinery or natural gas processing plant. The production process requires large quantities of fuel, water, and steam, which can be recycled in an integrated petrochemical complex. Saudi Arabia has located most of its new petrochemical facilities at Jubail, where they benefit from close proximity to gas processing plants, oil refineries, and loading facilities.

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Petrochemical plants need to operate near capacity to be profitable. Moreover, small plants tend to be less efficient producers. The large new plants in Saudi Arabia and in other oil-producing countries provide a stiff challenge to Western producers. Many older facilities in the industrial countries are less efficient than the new plants in Saudi Arabia. Firms, particularly in Western Europe, face the difficult choice of closing some plants so remaining ones can operate near capacity or operating at lower output rates and thus sustaining heavy financial losses.

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Slightly more than half of the production will be aimed at the export market. The primary exports will be methanol and plastics, such as polyethylene and styrene, which are derived from ethylene. Other exportable products include linear low-density polyethylene (LLDPE), high-density polyethylene (HDPE), polyvinylchloride (PVC), styrene, ethylene glycol, and urea fertilizer. LLDPE is used for plastic bags and wraps; a large Saudi facility to produce this plastic is two months ahead of sched-

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DI IEEW 84-045
9 November 1984

Secret

Saudi Arabia: Status of Petrochemical Projects

Saudi Company ^a	Foreign Partner(s)	Location	Likely Completion	Estimated Cost (billion US \$)	Annual Production Capacity (thousand metric tons)
KEMYA	US firm	Jubail	Late 1984-early 1985	1.3	260
NAT METH	US firms	Jubail	Partly onstream	0.4	650
PETROKEMYA		Jubail	Late 1985	1.5	500
SABIC	Agip, Neste Oy	Jubail	Late 1984-early 1985	0.4	254
		Jubail	1986	Not available	500
SADAF	Shell	Jubail	Late 1984	2.8	2,060
SAFCO		Dammam	Onstream	0.3	450
SAMAD	Taiwan Fertilizer	Jubail	Onstream	0.4	500
SHARQ	Japanese Consortium	Jubail	Mid-1985	1.5	130
S-METH	Japanese Consortium	Jubail	Onstream	0.3	600
YANPET	US firm	Yanbu	1986	2.5	510

^a KEMYA Al-Jubail Petrochemical Company
 NAT METH National Methanol Company
 PETROKEMYA Arabian Petrochemical Company
 SABIC Saudi Arabian Basic Industries Corporation
 SADAF Saudi Petrochemical Company
 SAFCO Saudi Arabian Fertilizer Company
 SAMAD Al-Jubail Fertilizer Company
 SHARQ Eastern Petrochemical Company
 S-METH Saudi Methanol Company
 YANPET Saudi Yanbu Petrochemical Company

ule. HDPE is used for, among other things, plastic bottles; PVC for phonograph records; styrene for styrofoam and as an input for synthetic rubber tires; and ethylene glycol for antifreeze and as an input for polyester when combined with methanol.

When all Saudi petrochemical plants are completed and operating at capacity, they will produce about \$3 billion of exportable products at current market prices. With estimated 1984 oil exports of at most \$44 billion and a current account deficit of \$15 billion, the petrochemical exports have taken on a higher priority than would have been the case in 1981, when Saudi oil exports surged to \$110 billion.

The Saudi Cost Advantage

Saudi Arabia will be able to undercut prices of its US, West European, and Japanese petrochemical competitors because of its input cost advantage. Natural gas is available to Saudi petrochemical producers at 50 cents per million British thermal units (Btu). In contrast, prices for natural gas feedstock range from about \$2.70 to \$4.85 per million Btu in the United States, Europe, and Japan. Even more expensive is the liquid naphtha feedstock that is used in most West European and Japanese plants.

The variance of feedstock input costs of as much as 10 to 1 overstates, however, the overall Saudi cost

Secret

9 November 1984

Secret

The Master Gas Gathering System

To eliminate flaring of natural gas produced with crude oil (associated gas), the Saudis last year completed a \$15 billion gas gathering system. This makes the development of a large-scale petrochemical industry possible. In addition, the master gas system provides processing facilities and pipelines for Saudi exports of liquefied petroleum gases and transports gas to electric power and water desalination plants. The Saudis plan to expand the current gas gathering system to include nonassociated gas, primarily from the undeveloped Khuff discovery. Development of nonassociated gas will eliminate Saudi Arabia's need to produce crude oil to provide adequate domestic gas supplies.

advantage. Other inputs can be more expensive in Saudi Arabia. Moreover, naphtha-based production yields a mix of high-value coproducts that compensates for its higher price. Nonetheless, even after adjusting for these differences, we believe Saudi Arabia has at least a 2-to-1 cost advantage over developed country producers.

The impact of low-cost Saudi petrochemicals already is being felt. The United States, for example, became a net importer of methanol in the first four months of this year because of new, lower priced supplies available from Saudi Arabia and Trinidad. According to a Department of Commerce spokesman, it costs US firms 40 cents to produce a gallon of methanol they can import for only 33 cents. One major US firm, citing low-cost imports, is shutting down a 675,000-ton-per-year methanol facility in Texas next January.

Selling in a Saturated Market

"The Petrochemical War Between the Arabs and the West Has Started" was the headline last spring in a French publication that covered King Fahd's attendance at a plant's opening ceremonies in Jubail. Market demand for petrochemicals had grown spectacularly before 1974. After the sharp

jump in oil prices, demand declined both because of higher feedstock prices and because of economic recession.

By late 1983, as Western Europe began pulling out of recession, it was still saddled with excess ethylene capacity despite extensive plant closures. For example, during 1981-82, 24 percent of West Germany's 1980-level ethylene capacity was shut down, 33 percent in the United Kingdom, 19 percent in France, and 49 percent in Italy. Europe still has excess ethylene capacity of 21 percent, or 3 million tons, even without considering the impact of Saudi imports. Further cuts will be politically difficult because obsolete, high-cost plants already have been shut down. Indeed, a spokesman for BP Chemicals recently warned that the intransigence of the West European producers should not be underestimated.

The methanol market in Western Europe and Japan also suffers from excess capacity. Moreover, an additional 5.7 million tons of capacity—a 42-percent increase—will come onstream worldwide in 1984-85. One-fifth of this new capacity is in Saudi Arabia. global methanol

Secret

9 November 1984

Secret

A Primer on Petrochemicals

Petrochemicals are compounds containing carbon and hydrogen, which are derived from natural gas, natural gas liquids, or other feedstocks. Basically, petrochemicals are obtained by "cracking"—applying heat and pressure—a heavy hydrocarbon molecule to create lighter hydrocarbon molecules that then react with other chemicals to form new compounds.

To produce petrochemicals from natural gas, a processing plant strips the gas of its liquids, mainly propane and butane. The remaining dry gas consists predominantly of ethane and methane. These gases are processed to produce two basic petrochemical building blocks—ethylene and methanol. Ethylene, a gas, is used primarily to produce a wide range of plastics, such as polyethylene, polystyrene, and polyvinylchloride. The liquid methanol is used to produce formaldehyde, polyester, and other petrochemical products used in industry.

Most of Saudi Arabia's competitors in Western Europe and Japan derive ethylene and a wide variety of coproducts by cracking naphtha. Naphtha is a refined product derived from crude oil and, being liquid, is easily transported. Methanol in the industrial countries, as well as in Saudi Arabia, is produced from natural gas.

consumption will rise from a 1983 level of 10.6 million tons to only 11.6 million tons in 1985. If Saudi Arabia is producing at its full 1.25-million-ton capacity, its output would account for 11 percent of 1985 demand.

Saudi Free Trade Strategy

Faced with this soft market, the Saudis are appealing, particularly to the West European nations, for free trade. They have based their argument on reciprocity. Minister of Industry and Electricity Abd al-Aziz al-Zamil notes that 47 percent of all

West European products enter the kingdom duty free. The remaining imports carry tariffs of only 3 to 4 percent. The Saudis thus argue that it is unfair that Saudi exports should face EC tariffs of 12 to 19 percent.

The Saudis also argue that cutbacks in obsolete capacity would benefit all and that high-cost producers should concentrate on more diverse, higher value-added specialty petrochemical products. The Saudis claim they have no unfair cost advantage and that focusing only on feedstock and energy costs is misleading because Saudi Arabia has other costs that are considerably higher than their competitors. These include construction with imported materials, operations and maintenance in a harsh climate, the need for high-salaried expatriate personnel, and the expense of training programs for Saudis.

As yet unstated in Saudi trade arguments is the possibility that the Saudis will threaten to limit access to Saudi crude oil or to redirect their purchases abroad as a lever in trade negotiations. Given the soft oil market, we believe Saudi attempts to link oil sales to petrochemical trade barriers probably would fail. The large Saudi import market—\$6 billion from Western Europe this year—offers greater leverage.

Trade Frictions

In our judgment, Western Europe, rather than the United States and Japan, will be the focus of trade restrictions against Saudi petrochemical exports. Japanese and US firms are joint partners with the Saudis in developing these new facilities. Furthermore, US, Japanese, and Korean firms have won the lion's share of design, engineering, and construction contracts for these and other industrialization projects in Jubail and Yanbu. Firms from both the United States and Japan already have commitments to market a share of the Saudi output. Japanese concerns over future access to crude oil and over the promoting of plant and

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Secret

9 November 1984

Secret

equipment sales apparently outweighed protecting Japanese producers. Many of these Japanese firms are diversifying into a wider range of petrochemicals. []

quantitative restrictions on Saudi petrochemicals or increases in the current 5- to 10-percent tariffs on petrochemicals. []

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By contrast, the West European market not only is vulnerable to low-cost Saudi products but also is deeply concerned about protecting high-wage jobs. Unemployment in Western Europe currently is hovering at 11 percent. []

The consideration of protectionist measures against Saudi exports by Washington would prompt the Saudis to weigh in at senior levels of the US Government. We doubt the Saudis would directly threaten retaliation against US exports. Instead, the Saudis would be more likely to cite the importance of the petrochemical industry to the kingdom and stress the need to maintain good Saudi-US relations. We believe the Saudis would expect US firms to make more explicit the potential for Saudi trade retaliation. []

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In late June the European Community denied a Saudi request for a tariff exemption and slapped a 13.5-percent tariff on Saudi methanol imports. This occurred after imports from the Saudis shot up from nothing in early 1983 to an annual rate of 600,000 tons this year. West European arguments for tariffs include the need for protection while industrial restructuring occurs and the strategic importance of retaining a viable petrochemical industry. []

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The Saudis responded in early October by imposing a 20-percent tariff on imported electrical cable. We believe, however, that the Community will not back down from restrictions against Saudi petrochemicals. A working meeting of Arab League and EC representatives on petrochemicals is scheduled for next February. Given the inexperience of many Saudi officials in dealing with trade disputes, these frictions could escalate into a major political issue between the Saudis and Western Europe. []

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Implications for the United States

Those US firms involved with Saudi Arabia as partners in petrochemical production stand to gain from the forthcoming surge in low-cost Saudi output. Many of these firms are already preparing to use Saudi petrochemical products as inputs for the production of specialty petrochemicals. US bulk petrochemical producers, on the other hand, face competition from the Saudis in an already glutted market. Some US firms could well seek

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Export Processing Zones: Contributions to LDC Development

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During the last 15 years, export processing zones (EPZs) have become a rapidly growing phenomenon in developing countries. These enclaves provide industrial infrastructure—including buildings, power, and roads—as well as special tariff, fiscal, and regulatory concessions, and have become an important mechanism for attracting export-oriented foreign investment to developing countries. Through their investments and operations, the export-oriented industries generate foreign exchange earnings and provide employment opportunities that contribute to LDC export and industrial development.

The developmental impact outside the enclaves, however, has not been as significant, mainly because investments have been concentrated in labor-intensive assembly industries that do little to enhance the labor skills or technological capabilities of the host country. Given the outgrowth of new technologies that are automating labor-intensive assembly operations of traditional zones, we believe the focus of future EPZ operations will probably gravitate toward data entry and other labor-intensive service industries.

A Stimulus for Private Investment

EPZs have become a significant mechanism for attracting export-oriented foreign investment. Zone administrators indicate that by creating climates favorable to small- and medium-sized enterprises, the zones attract many firms that normally avoid unfamiliar political and regulatory environments. In 1970, only eight zones were operating in eight countries. By yearend 1982, 109 EPZs were established in 38 developing countries. According to the

United Nations Industrial Development Organization, the zones' net addition to foreign investment in EPZ host countries over the past decade totals \$10-15 billion. Most EPZ investments are concentrated in labor-intensive assembly industries. Electrical and electronics industries account for 53 percent of EPZ exports, textiles and garment industries for 14 percent, and food products and tobacco industries for 6 percent.

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Several developed country trade preference programs provide a major stimulus to private-sector resource flows to developing country EPZs. In particular:

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- US Tariff Concessions 806.3 and 807 permit US products to be assembled and processed overseas and returned to the United States free of duty for the value added by operations performed abroad. Garments from the border zones of Mexico have especially benefited from these provisions, as have electronics exports from Malaysia.
- The Caribbean Basin Initiative (CBI) has expanded a duty-free window to the US market for most -- 25X1 Caribbean and Central American export industries.
- The Generalized System of Preferences (GSP) offered by most developed countries provides preferential tariffs on most manufactured and semimanufactured products from developing countries. Changes in the US program, which would limit duty-free access for the most advanced LDCs, are accelerating the outflow of investment particularly from the Asian newly industrializing countries (NICs)—Hong Kong,

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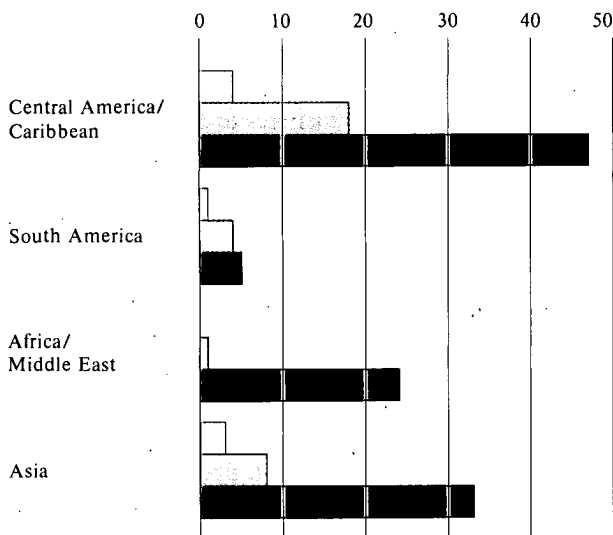
DI IEEW 84-045
9 November 1984

Secret

Growth in Third World Export Processing Zones

Number of EPZs

□ 1970
 □ 1975
 ■ 1982



Singapore, South Korea, and Taiwan—to EPZs of developing countries retaining full GSP privileges.

- The Multifiber Arrangement, which sets export quotas on developing country garment and textile industries, has also been a major stimulus to some EPZs. As traditional textile producers have reached their export quota limits, firms have diversified into EPZs located in such non-quota-bound countries as Mauritius.
- The Lome Convention has enabled more than 40 developing countries to export manufactured products into the European Community at low or no duty. It has been a primary stimulant to EPZ activity in former African, Caribbean, and Pacific region colonies.

Political-economic conditions have also affected the direction and success of capital flows into LDCs:

- A stable investment climate seems to be very important to a zone's success. We know of no successful zones in countries suffering from endemic civil unrest or military strife. The recent capital flight from Hong Kong suggests that even exceptionally attractive basic factors of production will not hold entrepreneurs when a country's stability is seriously questioned.
- Another major attraction to foreign investors is access to a low-cost work force and domestic or foreign suppliers of competitively priced raw materials and intermediate goods.
- Simple, blanket incentive programs tend to predominate in successful EPZs. Although the extent and duration of the incentives are important, most foreign investors are more sensitive to the regulatory and paperwork requirements for investment applications and operating permits. Zones in India and Honduras have lost several investment opportunities because of the difficulties and delays in securing necessary approvals.
- Successful EPZs have a dependable power and water supply, low transportation costs, nearby housing, and adequate building facilities. Private EPZ developers have been more successful in ensuring basic amenities and services than their public-sector counterparts.

- Effective administration is a final factor that we found to be important in affecting a zone's relative success. Although this role has been effectively handled by both the private and public sectors, the financially successful zones are invariably privately managed. Public-sector zones in Mexico and Mauritius, for example, have lost a number of potential tenants because foreign investors found nearby privately operated zones to be more responsive to the maintenance and service needs of companies operating there.

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Secret

9 November 1984

Secret

Impact on Development

The most significant contributions of EPZ to the host countries are additional employment opportunities and increased foreign exchange earnings. The most successful EPZs are in Malaysia, Mexico, Singapore, South Korea, and Taiwan. In other developing countries, the EPZs have served only as a marginal instrument in promoting economic growth and development. []

The high concentration of foreign investment in labor-intensive industries has significantly boosted job creation in EPZ host countries. Our analysis indicates that the net gain in direct employment totals almost 1 million jobs for EPZs in developing countries. The zones in China, Taiwan, Malaysia, Singapore, and South Korea have generated the most jobs, accounting for 50 percent of the total. Next in importance are the Caribbean and Central American zones, which account for some 28 percent of the jobs, largely because of the employment generated in the border zones of Mexico. Indirect employment generated by EPZ industries is also significant. Estimated to total 350,000, the indirect jobs are concentrated in service and feeder industries. The indirect employment effects have been greatest in countries such as Malaysia and Taiwan, where linkages with local feeder industries through the purchase of domestic raw materials and intermediate goods are strong. []

The EPZs account for a still small, but growing share of LDC exports. In 1982, for example, EPZ exports totaled \$7.5 billion, roughly 6 percent of the developing countries' total manufactures exports. The amount of foreign exchange actually earned by the host countries after the foreign exchange outlays on imported inputs, repatriated profits, and other capital outflows are subtracted, however, varies widely. Countries realizing substantial net foreign exchange earnings from their EPZs include Taiwan, Malaysia, Mauritius, the Dominican Republic, and Mexico. Other EPZs—notably in Senegal, Costa Rica, Guatemala, and Colombia—have realized little or no net earnings, or worse, have sustained losses because of the foreign exchange costs for zone infrastructure development. EPZs generating large net foreign ex-

change earnings generally have a high local value-added content, ranging from 30 to 50 percent of exports compared with the typical added value of about 25 percent for newly established EPZs. []

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Other benefits to an EPZ host country include dispersion of industry away from urban centers or increased use of domestic raw materials and intermediate goods. The Kandla zone in India and the Bataan zones in the Philippines, for example, were established mainly as alternatives to the countries' congested major seaports. Moreover, EPZs serve as a "proving ground" for basic policy reforms. Taiwan and South Korea, for example, used their EPZs as demonstration areas for market-oriented policies before their introduction nationwide. The EPZs' success later enabled advocates in these two countries to press for a shift from import substitution to export-led development strategies. Reducing tariffs, taxes, and regulations in targeted areas can have powerful demonstration effects, at far less political cost than by overhauling economic policies nationwide. []

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Export processing zones, however, have not been an important source of technology transfer or labor and management skills. To take advantage of the large labor-cost differentials between developed and developing countries, foreign firms move only the labor-intensive stages of their production processes to EPZs. Preassembly and other stages requiring advanced technology usually remain in the developed countries. As a result, the production processes in the zones generally are not technically sophisticated and offer employment opportunities mainly for unskilled and semiskilled labor. Where worker skills are upgraded, they differ little from job skills outside the zone. Moreover, the zones rarely develop linkages to domestic enterprises because they usually rely on foreign suppliers. []

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Future Trends

We believe a number of factors will lead to an increase in EPZ use by developing countries during

Secret

9 November 1984

Secret

the next one to three years. A recent stimulus to zone development is the CBI, which, according to zone administrators, is creating a surge in US and Asian investor interest that already has contributed to the leasing of all available prebuilt factory space in Jamaica and the Dominican Republic. They expect this trend to begin in other established zones as investors in the NICs, which are losing many of the cost advantages previously inherent in their domestic economies, become increasingly attracted to the Caribbean. [REDACTED]

A further stimulus to zone development was the recent surge in capital flight from Hong Kong, caused by investor uncertainty over the Colony's future. Zone managers report that the long-idle inventory of prebuilt standard factory buildings in the Coromandel EPZ of Mauritius has been leased out during the past year to Hong Kong firms seeking a more stable base of operations. We believe the growth in EPZ use will also be spurred by the NICs as they shift the manufacturing operations for products that are losing preferential access to developed country markets to EPZs in developing countries still receiving developed country tariff concessions. [REDACTED]

We believe the form of EPZ operations will also change. As developed countries erect additional tariff and nontariff barriers to selected manufactures imports, the opportunities for many of the LDCs' traditional labor-intensive, zone-based, assembly industries is reduced. Moreover, as the automation of labor-intensive assembly operations accelerates, we believe the zone's ability to attract its historical shares of routine assembly and manufacturing operations will suffer. Already, leading US firms are automating the manufacture of textiles and electronic components and relocating their plants in or near final markets. [REDACTED]

Although automation will weaken the comparative advantage of traditional labor-intensive assembly industries, we believe the changing technologies will generate new opportunities for production sharing. The advent of low-cost microcomputers has already resulted in a substantial growth of "offshore data-entry" operations in the past five years. In these operations, large masses of corpo-

rate data are entered into offshore electronic data banks and are then transferred to corporate headquarters for processing and analysis. Several US firms report savings of up to 50 percent because of the substantially reduced labor costs in offshore data-entry zones in the Caribbean. This trend is likely to extend to other labor-intensive service industries. We believe developing countries that use their EPZs to widen access to more sophisticated skills and technologies will probably substantially improve their trade and growth performance. [REDACTED]

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Secret

9 November 1984

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Next 1 Page(s) In Document Denied

Secret

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